# DOW THEORY LETTERS INC.

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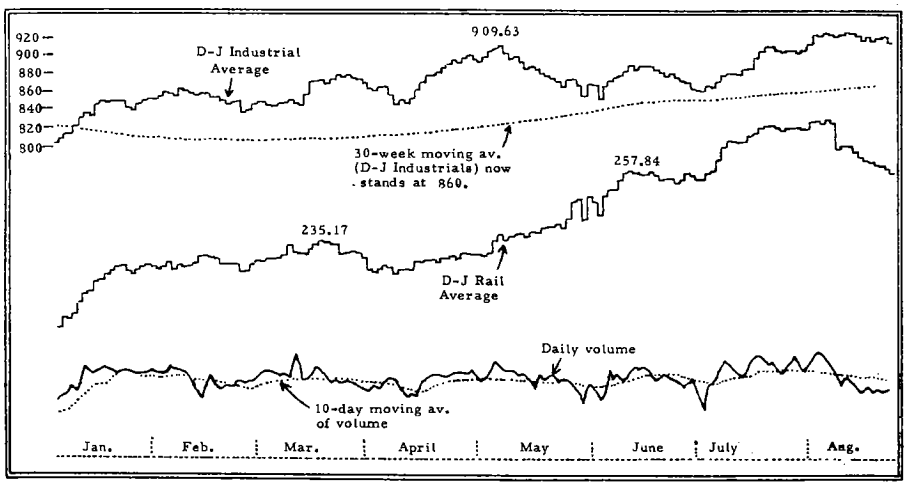
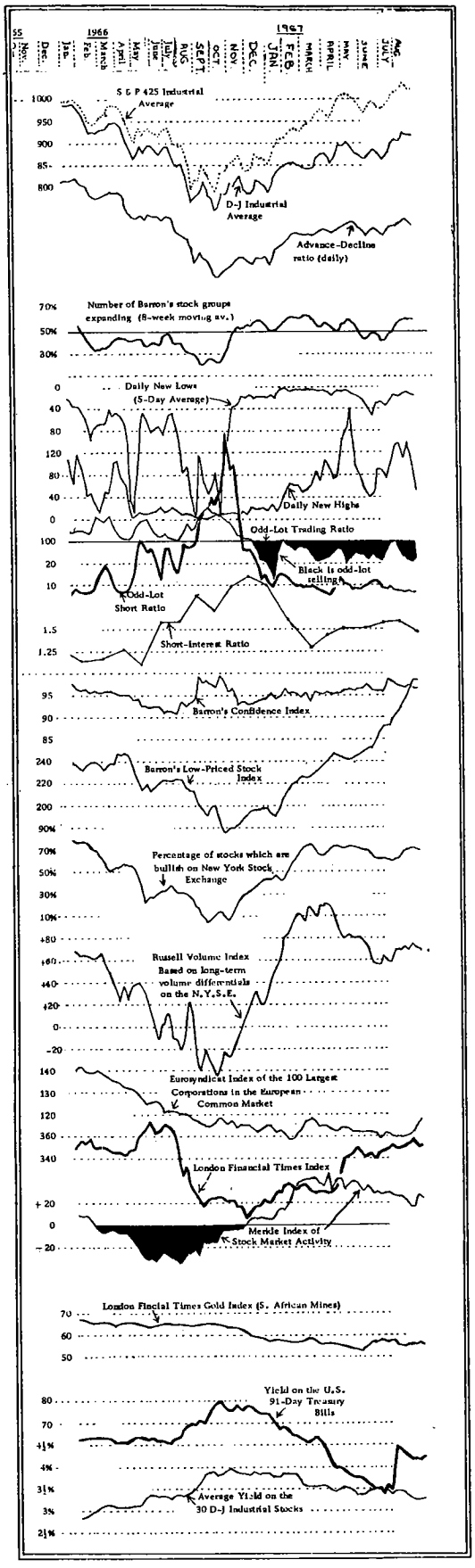
THE MARKET: The latest Gallup Poll shows that the American people's approval of President Johnson's handling of the Presidency has dropped to its lowest level since the President assumed office. Only 39% of those polled now approve of Mr. Johnson's actions. The latest Harris Poll concurs in the 39% rating, and this is down 19% from the 58% high touched after the Glassboro "summit" conference in late June. My feeling is that the pollsters "ain't seen nothing yet." After all, the Vietnam war, the racial conflagrations, the talk of tax hikes, the flood of mealy-mouthed statements from the Administration, all this has come within the context of a strong economy. What happens when the market runs out of speculative steam, and the primary bear forces take hold again? What happens when the economy starts slumping, and the nation starts facing reality in the economic area?

We can then expect the President's popularity to drop to about 10%. Yes, I firmly believe that before the next (1968) Presidential election we will see a period where the President's popularity has dropped so low that he will be forced to take drastic action. Such action could include a sudden ending of the Vietnam war or perhaps going to the people with some sort of an emergency plan for "getting the country movin' again" (as per Roosevelt or Kennedy).

Meanwhile, the "splintering process" continues to eat at the guts of this extraordinary bear market rally. Last week the D-J 40-Bond Average dropped to another new low since 1933. At the same time the yield on the broadly representative 40-Bond index rose to 5.9, just a tiny fraction under 6%. The money markets are obviously worried about the chances of passing LBJ's newly proposed 10% surtax, and they are also worried about the drop-off in corporate tax receipts to the Government. The Administration is now openly admitting to a $29 billion budget deficit if the surtax is not passed. But this writer is beginning to have an uneasy feeling about the surtax being passed at anything like the terms the President asks. And if the stock market breaks here and corporate profits head down, we could face the incredible dilemma of Congress refusing to raise taxes in the face of a shaky Wall Street, and this in turn pushing the deficit up into the stratosphere (while corporate profits continue to drop and Government tax receipts continue to shrink).





1966
1967
S & P 425 Industrial Average
D-J Industrial Average
Advance-Decline ratio (daily)
Number of Barron's stock groups expanding (8-week moving av.)
Daily New Lows (5-Day Average)
Daily New Highs
Odd-Lot Trading Ratio
Black is odd-lot selling
Odd-Lot Short Ratio
Short-Interest Ratio
Barron's Confidence Index
Barron's Low-Priced Stock Index
Percentage of stocks which are bullish on New York Stock Exchange
Russell Volume Index Based on long-term volume differentials on the N.Y.S.E.
Eurosyndicat Index of the 100 Largest Corporations in the European Common Market
London Financial Times Index
Merkle Index of Stock Market Activity
London Fincial Times Gold Index (S. African Mines)
Yield on the U.S. 91-Day Treasury Bills
Average Yield on the 30 D-J Industrial Stocks

Meanwhile, the stock market itself is also showing signs of splintering under the shadow of the powerful financial forces outlined. The Rail Average broke wide on August 8 as speculators dumped shares in Chicago Northwestern (in the face of Chicago's cancellation of merger talks with Essex Wire). This break would perhaps not be so significant except that (1) Chicago Northwestern also figured heavily in the recent advance of the Rail Average, and (2) Chicago's performance was characteristic and in line with other recent collapses in speculative shares. After the frenzied speculative advance of 1966-67, I consider the piecemeal cave-in of selected speculative leaders to be most significant and not to be taken lightly. Many advances of the past have been signalled by the sudden collapse of one or more important issues (such as the drastic slide in American Telephone just before the 1946 crash).

Nevertheless, in the face of the ragged market Barron's Low-Priced Stock Index rose to another all-time high of 314. Activity on the Amex continued to be highly speculative with many "cats-and dogs" and "junk stocks" churning within the peak area of their recent stilt-formations. And behind the whole speculative scene stood the U.S. Administration, an Administration which is cynically willing to go to any length in its effort to perpetuate a boom in the stock market and the economy.

The breadth of the market (advance-decline ratio) is moving into an interesting position on the N.Y.S.E. On August 4 the A-D ratio rose to a recovery high for the entire advance since the October, 1966 low. A slight decline ensued, and this was followed by a further new high for the Industrial Average. The new high was not confirmed by the A-D ratio. A second decline followed. The Industrial Average now seems to be embarked on a third recovery move, a move which could take the Dow to a new recovery high above the 926.72 peak of August 9. If such a move does materialize, it will be most important to see whether the A-D ratio can confirm (above its August 4 high). If the A-D ratio cannot confirm such a move by the Dow, we will have the formula for an extended or "triple divergence" between breadth and price. Such divergences have preceded many important declines in the past. This is the technical position the market may be placing itself in now, and consequently breadth and price should be watched carefully over the period ahead.

AS TIME GOES BY: "There are some definitely encouraging elements. The ratio of casualties between Government and Viet Cong forces, the ratio of arms captured, .....the steady extension of the strategic-hamlet program, .....all those indicate some turning in the situation."—Dean Rusk, February 1. 1963.

"The momentum of the Communist drive has been stopped." —Dean Rusk, February 13, 1963.

"The South Vietnamese themselves are fighting their own battle, fighting well." —Dean Rusk, April 18, 1963.

"There is a good basis for encouragement. The Vietnamese are on their way to success and needed our help." —Dean Rusk, April 22, 1963.

"Secretary McNamara and General Taylor reported their judgment that the major part of the US military task can be completed by the end of 1965, although there may be a continuing requirement for a limited number of US training personnel." —White House statement, October 2, 1963.

"We believe that the present (Saigon) regime has moved promptly to consolidated public effort, and that the people of that country will move in greater unity on behalf of the total effort." —Dean Rusk, November 8, 1963.

"I think the resources and capabilities are there to get this job done on the present basis of assistance to the Vietnamese so that they themselves can handle this problem primarily with their own effort." Dean Rusk, February 24, 1964.

"I think they (the Viet Cong) have very serious problems— not only in fact, in terms of losses, disruptions, but in terms of morale. So I am not pessimistic about the situation." —Dean Rusk, July 1, 1964.

".....Small numbers of the US personnel will be able to return by the end of this year." — Robert McNamara, November 19, 1963.

"I am hopeful we can bring back additional numbers of men. I say this because I personally believe this is a war the Vietnamese must fight.....I don't believe we can take on that combat task for them." Robert McNamara, February 3, 1964.

"I think on balance the number (US training personnel needed in Vietnam) is not likely to increase substantially." — Robert McNamara, May 14, 1964.

"The most vital impression I'm bringing back (from Vietnam) is that we've stopped losing the war." Robert McNamara, November 30, 1965.

"We are beginning to see some signs of success of this strategy.....The number of defections this year has doubled compared to the past year. No doubt this is a sign of erosion of morale." —Dean Rusk, August 25, 1966.

"I do believe that one basis for optimism is that the other side must surely now understand that they are not going to succeed in seizing South Vietnam by force." —Dean Rusk, January 1, 1967.

"I think we have seen some very favorable signs that we are making headway on the military side..... I must say that I have been impressed by the doubling of the rate of defectors from the other side." Dean Rusk, April 16, 1967.

"During the past year tremendous progress has been made.....The enemy has not won a single, significant victory during the past year, despite the tremendous effort that he has put forth."—General Westmoreland, July 13, 1967.

"Suffice it for me to say that we are generally pleased with the progress we have made militarily. We are very sure that we are on the right track." —President Johnson, July 13, 1967.

"The other side is hurting, and they are hurting very badly." —Dean Rusk, July 19, 1967.

THE FINANCIAL STORM: Even the "liberal columnists" are looking aghast. In his August 6 New York Times editorial, Editor James Reston writes: "The unsolved problem which LBJ will not face and which the people intuitively understand.....is the problem of priority. It is true that the U.S. can spend more money on the cities and on Vietnam this year than last, but it is not true that we can deal effectively with the war in Vietnam, the problem of the cities, the flight to the moon, the health, education and welfare of all the people, the new class war between the rich nations and the poor nations, pork-barrel appropriations for all the states and cities, veterans' aid, foreign aid, debt reduction and the balance of payments— all these things at the same time. This is what the Administration is trying to do, and in the long run it is likely to be both bad policy and bad politics."

In my mind, even Mr. Reston is in dream world. Note the clip from last week's Christian Science Monitor. The fact is that New Economists in Washington have over-estimated the Government tax-take by about $3 billion so far in 1967. If the market runs into trouble and profits continue to contract during the remainder of 1967, the shortage will go well over $3 billion.

This shortage is one of the reasons that LBJ has asked for a 10% surtax. But in my opinion, the horns of the financial dilemma are now looming larger than ever. The surtax or something like it may pass Congress if business holds up. But the surtax itself will squeeze profits all around, thereby boosting the Government deficit. On the other hand, if the stock market caves in Congress will probably dare not pass a surtax. In that case, with corporate earnings falling and the tax-take receding, the budget deficit will climb into the absolute stratosphere. To put it another way, A stock market bust here could push the national deficit above $35 billion in my opinion. This would work so disastrously on the bond and money market that I would expect to see utter chaos envelope Wall Street and the nation's businessmen.

# *Surprised economists revise tax estimate*

**By Philip W. McKinsey**
*Special correspondent of*
*The Christian Science Monitor*

**Washington**

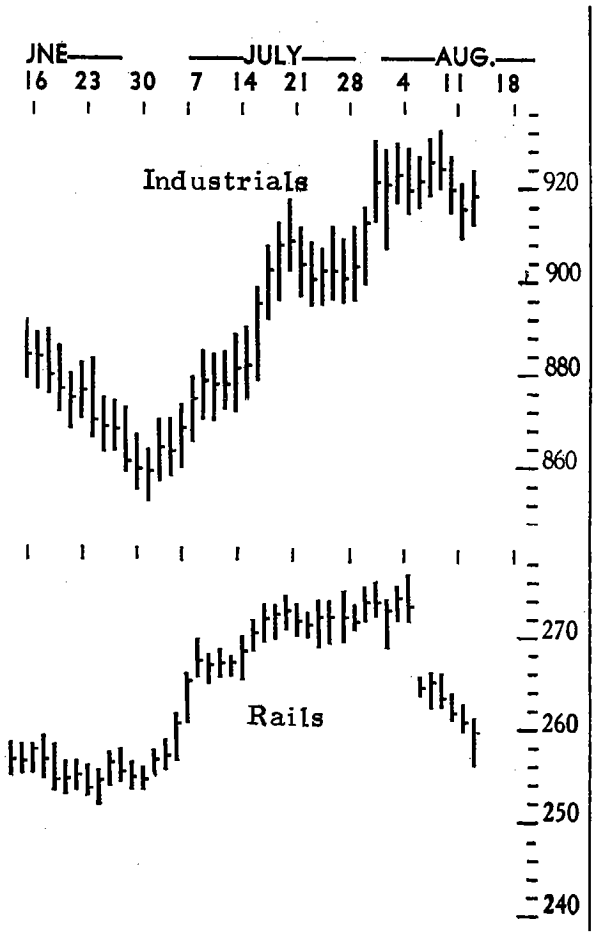
Government economists who pride themselves on the advanced state of their "science" are having a tough time explaining how they managed to overestimate tax revenues for the current fiscal year so badly.

The less-than-expected tax take is a major factor in the looming deficit which has prompted President Johnson to ask for a 10 percent surtax.

In January, the administration estimated that revenues for fiscal 1968 (which began July 1) would be $127 billion. Now they have revised that down to $120 billion — the first time in several years that revenues will be less than expected. During the past few years revenues that exceeded expectations enabled the President to come up smiling at the end of the year, showing a smaller deficit than predicted.

In the last Letter, I published a very long-term chart of interest rates. That chart shows interest rates rocketing to a 100 year high. Is it any wonder? Suddenly, the fiscal nonsense of the last 30 years is on the edge of going completely out of control. The U.S., which has been on a drunken spending jag for a generation, is finally on the edge of the precipice. The dollar is reeling, and the pound sterling is sinking. The D-J 40-bond average is selling little better than 75¢ on the dollar. The mountain of credit which has been built up inside the U.S. is beginning to splinter and crack. The whole picture is almost too big, too frightening to contemplate. But study it we must. And this writer will continue to call the shots as he sees it.

TECHNICAL PHENOMENON: Robert Rhea, the great Dow Theorist, stated that "gaps" played no part in Dow Theory, and he wrote little or nothing about them. I occasionally give gaps more credence. A gap is a space on a high-low chart which develops when the opening price on a given day is far above or below the closing price of the preceding day. When price continues in the direction of the force which produced the gap, we say that the space or gap on the chart is not closed. An old Wall Street adage has it that "gaps are always closed," but in my observation this is nonsense. There have been many gaps in individual stocks and the Averages which have never been closed. Some stocks gapped down in 1929 and went out of existence a few years later, thereby leaving gaps that were obviously never filled.



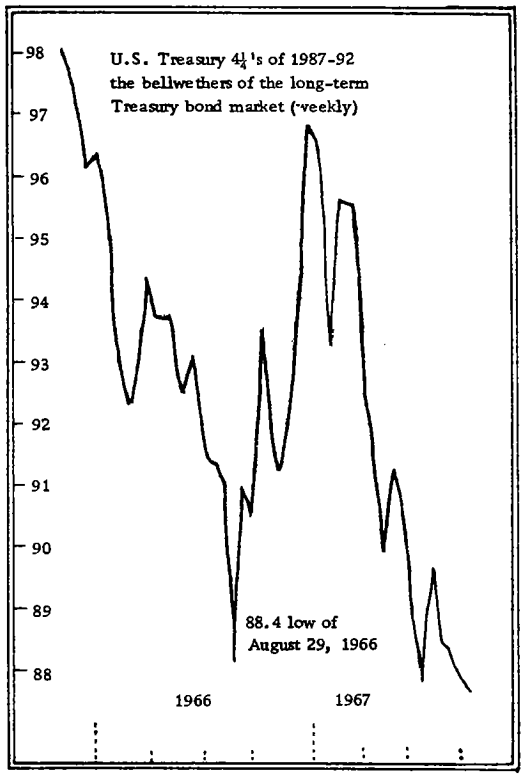

A gap, from the purely technical viewpoint, is produced when the force (up or down) is so powerful that the even flow of price movement is violently interrupted. Because gaps are so rare in the Averages, I want now to draw readers attentions to the remarkable gap which has recently materialized in the Rail Average (see accompanying clip from the Wall Street Journal). This gap was produced when Chicago Northwestern caved in, yet I hesitate to write off the power and importance of this gap in the Rail Average as just a technical consideration based on a single stock.

If Chicago alone was responsible for the entire Rail weakness, then we might have expected this gap to be "filled" as the majority of Rails moved higher again. But the interesting factor here is that this gap seems to have been formed almost from "exhaustion," as the entire Rail Average strained under the burden of speculative excess on the upside.

Since the appearance of the gap, the Rails have sunk steadily lower, seeming to drag the Industrials and the rest of the market with them. Much of the speculative momentum of the market seems to have withered with the formation of the powerful downward gap in the Rails. It will

 be interesting to see whether the exhaustion in Rails signalled the end of the 1966-67 advance for the market.

BELLWETHER: The accompanying chart traces the weekly closing bid on the Treasury 4¼ of 1987-92. This is the bond (issued in 1962) which every bond trader in the nation watches. It is the "General Motors" of the bond world.




Last week the 4¼ broke back under its 88 support level, thereby dropping to the lowest level since it was issued five years ago. At slightly above 87 (actually $870), this prime piece of U.S. Treasury debt is now selling at 87¢ on the dollar. It's a bitter pill: but this is the market's cold appraisal of what U.S. debt is really worth. At 87¢ on the dollar, the market is saying that the U.S. cannot handle its finances and that its prime long-term debt will bring new buyers in only at a deep discount from the original purchase price.

Meanwhile, I thought this little ad was interesting. With no more silver certificates around, speculators are now offering 25% over face value for original U.S. money, money that was backed by the intrinsic value of a precious metal, silver. This might be a good lesson for those who have claimed that "paper money" will ultimately be as good as gold-backed or silver-backed money. When your New Economics friends tell you this, show them this little ad. If paper money is as good as money backed by gold or silver, why are speculators now offering a premium of 25% for real money? It's an interesting question.

**BUYING SILVER CERTIFICATES**
**PAYING 25% OVER FACE VALUE**
**$1, $5, or $10 Denominations**
**ANY CONDITION, ANY QUANTITY**
**SHIP VIA REGISTERED MAIL**
**IMMEDIATE AIRMAIL PAYMENT**
BANK REFERENCES ON REQUEST.
OUR STORE IS LOCATED BETWEEN
BROADWAY & NASSAU ST. IN LOWER N.Y.C.

PAGE 1 CHART: Referring to the composite chart on page 1, it is now noticeable that the Russell Volume Index is growing sluggish. This index, which has an excellent record of "calling" turns in the market, recorded a high of 114 in March of 1967. Since the index is based on the differentials of daily upside and downside volume on the N.Y.S.E. (in the form of roughly a two-month moving average), this would suggest that the March area saw the peak of strength for the market. From the March high, the Index broke to a low of 56 in June, 1967. As seen on the chart, the break in the Index called the May-June weakness in the market.

In early June the Russell Index turned up, and it touched a rather sluggish peak of 77 three weeks ago. The Index sank to 73 two weeks ago, then to 72 last week. Considering the weakness of the latest rise in the Russell Index and considering the two consecutive weeks of decline, I would say that the Index is flashing caution lights again. Any drop below the June 56 would be a most definite danger signal. Readers should watch this Index carefully over the next few issues.

On the same chart, my 5-day moving average of daily highs and lows has also flashed danger signals. Although new lows (5-day) are holding at around 15, the new highs have caved in, dropping from a recent peak of 154 (August 2) to an August 21 low of 51.

The Merkle Index hit its high in April, and has since trailed lower into the 25 area. The danger signal on this Index is anything under zero, and obviously we have not entered that area yet. But the Index is moving down.

CONCLUSION: This Letter has covered many areas which I must term "danger spots." I feel that this market is moving into the really "thin ice" stage, and I once again warn all subscribers to get out of their common stocks (except gold) and into short-term Treasury bills.

My belief is that the true second phase of this primary bear market will start when the 1966-67 (upward) correction tops out and the bear market resumes again. Remember, the second phase of a primary bear market is the one in which the stock market declines in reflection of obviously deteriorating business conditions. Following the second phase, we should have another (but more subdued) correction, then a final slow, low-volume slide into the third phase. This is where the once-in-a-lifetime bargains in blue-chip and growth stocks will appear. At that point, we will load up, collect our dividends, be patient, and wait for the next great bull market.